Internal Revenue Service
memorandum

CC:TL-N-10255-91
FS:FI&P:LSMannix

date: OCT 29 1991

to: District Counsel, Manhattan NA:MAN
Attn: Vincent Guiliano (SLA)

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]: "Deep-in-the-Money" Call Options Trading Program

This responds to your request for our views on whether the taxpayer's writing of deep-in-the-money call options and the contemporaneous purchase of the underlying stock reduces the holding period of the stock, under section 246(c)(3), to the point that the taxpayer can no longer claim the dividends received deduction, under section 243(a)(1), for dividends paid on the stock. Upon review of the spreadsheet attached to your request that was prepared by the taxpayer's representative, we have determined that this case requires further factual development before the legal analysis is appropriate.

As we have previously discussed with you on October 22, 1991, our review of the Wall Street Journal for dates on which certain of these trades were purportedly made found us unable to reconcile the prices of either the options or the stock. Specifically, certain items in the spreadsheet have raised our suspicion that the trades, if they occurred, were prearranged by the taxpayer's broker; i.e., the purchases and sales, the purchase prices and sale prices and the accounts of the purchasing and selling entities may have been under the control of the taxpayer's broker. Further, the trades may have even been completely fictitious.

For example, on the first page of the spreadsheet, the data for the trades with respect to the [redacted] stock and the [redacted] stock indicate that the purchasers of the call options suffered larger losses upon exercising the options than they would have suffered if they had let the options expire and bought the underlying stock on the open market. Apparently, the premium paid for the options plus the exercise prices for the options were greater than the market prices of the stock on the date the options were exercised. (This preliminary analysis does not take into account the commissions the option purchasers probably paid which would increase their costs of the transactions.) Further, in both cases the options were exercised several months before they expired. Accordingly, the options purchasers could have

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waited to see if the market price of the stock rose sufficiently for them to make a profit before exercising the options.

We strongly recommend requesting the following documents from the taxpayer.

1. All the documentation that was used to construct the spreadsheet.

2. The confirmation slips for all trades and the account statements (monthly, quarterly and year-end statements).

3. Prospectuses, sales literature and other materials describing the program.

4. Copies of the account opening forms that were signed by the taxpayer; i.e., to show, among other things, whether the taxpayer gave the broker permission to make specific trades upon its own discretion, whether the account was a margin account (did the taxpayer borrow or lend stock?) and the amount of the commissions the taxpayer paid on the transactions.

5. Any documentation as to taxpayer deposits and withdrawals from the account.

6. Any documentation (receipts from the payor corporation) as to the payment of any dividends into the account.

7. Any documentation as to any lending or borrowing of stock by the taxpayer.

We recommend seeking responses to the following questions.

1. Whether the broker had discretion to make trades in the taxpayer's account without prior approval from the taxpayer. If so, when and how did the broker communicate its actions to the taxpayer.

2. Whether the taxpayer borrowed or lent any stock and, if so, what stock, when and to whom.

3. Whether the stock was purchased on an exchange, between the taxpayer's broker and another broker and/or between the taxpayer and another client of the taxpayer's broker.

4. Whether the options were sold and exercised on an exchange, between the taxpayer's broker and another broker

and/or between the taxpayer and another client of the taxpayer's broker.

5. How much cash did the taxpayer deposit in the account?

6. Did the purchasers of the options pay any commissions?

7. Why did the purchasers of the options always exercise the options on the forth business day before the stock went ex-dividend, allegedly forcing the taxpayer to purchase other stock to make delivery and still claim the dividend on the stock it had originally purchased?

8. Did the taxpayer provide any collateral for the account?

Many of these questions should also be asked of the broker via a summons. We have already provided you with a copy of the summons language to be adapted to this case.

In conclusion, we doubt the bona fides of these trades and urge that the case be developed in order to determine the proper basis for issuing a statutory notice of deficiency. If you receive additional information, we will be pleased to assist you in analyzing it.

If you have any questions, please contact Larry Mannix at 566-3325.

DANIEL J. WILES

By: Joel E. Helke

JOEL E. HELKE
Special Counsel
Financial Institutions and
Products Branch
Field Service Division